



# APPRAISAL BULLETIN

PUBLISHED IN THE INTERESTS OF REAL ESTATE ANALYST SUBSCRIBERS BY

DECEMBER 31  
1947

ROY WENZLICK & CO.

*Real Estate Economists, Appraisers and Counselors*

Copyright 1947 - by ROY WENZLICK & CO. - Saint Louis

Volume XVI

Number 61

## PLACING THE RISK

**T**HOSE important factors in the income approach in appraising values have been covered in previous bulletins but are again stressed because of their importance in their application to specific properties.

Except in the case of the fee and the leasehold estate (see November 1946 Appraisal Bulletin), when the land and improvements are severed into two properties under separate ownership and the net income allocated to the land by contract, practically all properties are single in use and single in net income, which is applied to the combined land and improvements. Even with the leasehold estate there is still a single net income of the property.

It is self-evident that the amount of net income allocated to the improvements is dependent upon the net income allocated to the land. Increasing the net income to one means decreasing the net income to the other. It is for this reason that it is so highly unethical and almost a cardinal appraisal sin to use the summation process which adds together the values of land and improvements appraised separately and often by different appraisers. Many of our courts allow the summation process and most assessors consistently use this method, claiming in excuse that State laws require separate valuations of land and improvements.

The greatest difficulty with summation appraisals occurs when the land is appraised for one use and the improvements are appraised for a different use. For example, the land will be appraised by comparison for commercial use or for large multiple dwellings, while the improvements consist of a single-family dwelling. In such cases the dwelling has no value because it has reached the end of its life from inadequate land use when the land is appraised at its potential use instead of its actual use.

We have often been asked when a property reaches the end of its economic or useful life. We always reply that we are unable to estimate the exact time in the future, but that the conditions under which a property ends its useful life occur when the net income in a normal period of balanced markets is insufficient to pay a return on the improvements. The net income may be sufficient to pay a return on the value of land, but the useful life ends when the residual improvements become without income and are valueless. It will be noticed that economic life is defined as ending under normal conditions. No doubt the end of economic life is hastened by periods of depression, when incomes of most properties drop to low levels, while, on the other hand, periods of booms and extreme activity restore net income and resuscitate a gleam of life.

In estimating the remaining economic life of any property the appraiser must

make the decision as to the period in the future during which the present value of the improvements can be recaptured with safety from property net income.

From Appraisal Bulletin No. 5 we quote the following:

"The estimate of remaining useful or profitable life of any particular property to be appraised depends upon the property itself, the existing status and environmental influences, and those trends which would affect the probable future status of the property. Properties with original weaknesses in layout, of poor construction quality and with fad or freakish architecture will suffer more rapid depreciation than those without these weaknesses. Neighborhoods with incongruous uses or with incompatible racial and standard of living types and those without proper zoning or deed restrictions, etc., create instability and shorten remaining useful life. Often high class residential districts are materially affected by the infiltration of racial types and those lacking conforming cultural qualities. Properties in business districts where the trend of activity is moving away or in neighborhoods which indicate rapid future deterioration and blight will have short future lives.

"We have estimated remaining useful lives for new properties as low as 25 years and as high as 50 years and for older properties of say 20 years, as low as 15 years and as high as 40 years, depending on the conditions surrounding the property appraised. In our opinion, there are no rules of thumb on life expectancy available to the appraiser, and reliance must be placed upon his experience and judgment."

Remaining economic life is one part of the pattern of estimated future net income. It represents the duration of the future income flow. The other part of the pattern is the amount of the future income flow. These phases of the pattern, both amount and duration of future net income, represent the estimate by the appraiser of the dollar equivalent and duration of the future utility of the property.

The utility of a property depends upon the following conditions:

- (1) The size, design, layout, construction quality, age and extent of deterioration, obsolescence and other depreciation influences.
- (2) The location, its accessibility, its environment in regard to congruity of uses, compatibility of use from racial and standard of living types, and protection by zoning and deed from adverse uses,
- (3) Neighborhood trends and population shifts, decentralization, etc.
- (4) The general cyclic changes affecting utility.

The existing utility of any property at any time results from the effect of play of these influences during its expended life. The effect on utility of the last two influ-

ences may be favorable or unfavorable. A favorable neighborhood trend increases values of all properties affected; sections in downtown districts and in outlying buying districts have been greatly increased in desirability and value by favorable trends which shifted business activity. At the same time values are lost by unfavorable shifts, decentralization, etc.

The loss and gain in utility from cyclic changes increases and decreases values perhaps to a greater extent than any other influence. The great losses in the utility and values of all types of properties from 1924 to 1932 were almost unprecedented. Likewise, the increase in utility and values from 1939 to 1947 probably surpassed all previous records.

The amount of future net income which the appraiser uses depends upon his estimate of the future utility of the property to be appraised. The more accurately the appraiser estimates the volume and duration of future net income, the less risk he must put in the capitalization rate. On the other hand, if present net income is used then all of the future risk must be included in the rate. The appraiser must compensate for risk either in the rate or in the future net income.

The future risk can be compensated for (1) by estimating the future level of rents; (2) by estimating the future loss in income due to vacancies and other losses; and (3) by estimating the future level of property expenses.

It has been our policy to compensate for risk by varying net income to meet our estimates of future utility. In this way we have stabilized our capitalization rate on practically all types of properties.

For example, in the February 1947 Appraisal Bulletin, "Conclusion of a Single Value," we had an actual existing net income without an allowance for vacancy of \$23,760 for a commercial property and appraised a value of \$136,000, which is the equivalent of using a capitalization rate of 17.7 per cent. However, in this appraisal we adjusted future net income to \$7,620 and used capitalization rates of 6 per cent on the land and 7 per cent on the improvements and an economic life of 25 years.

In the August 1947 Appraisal Bulletin, "Too Much Cost - Not Enough Income," we appraised a four-family flat with an actual net income without an allowance for vacancy of \$665 and appraised a value of \$13,300. This is the equivalent of using a capitalization rate of 5 per cent. In this case, our estimate of future net income was \$1,070, and the capitalization rates used were 6 per cent on the land and 7 per cent on the improvements, with a remaining economic life of 30 years.

In both of these appraisals the risk was compensated for in our estimates of future net incomes, and in both cases the identical capitalization rates were used.

It is not necessary to increase the capitalization rate as some appraisers recommend because a property is deteriorated and obsolete and approaching the end of its economic life; the future risk involved in such an extremely depreciated property should be covered by the future pattern of net income and the capitalization rate should be the same as for a new property of the same type.

We are not indifferent to that school of thought which claims that it is impossible to estimate the future utility of a property with any reasonable degree of accuracy and prefers to capitalize the existing net income with capitalization rates varying in amount, depending upon the future risk involved.

It is our belief that the risk is misplaced when the present is capitalized with the risk included in the rate of capitalization, whereas the risk concerns solely future net income.

It is evident that all capitalization processes concern future income and never past or present income. Also, all risk concerns the future income and never the past or present income. It would seem more logical to provide for risk in the future income pattern than in the rate.

*A. B. Kissack*  
A. B. KISSACK, M. A. I.

